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IN THE
SUPREME COURT OF THE UNITED STATES
October Term, 1972

No. 72-496

MORRIE BENSON, Petitioner,
v.
ARTHUR NEWMAN, et al., Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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CITATIONS

Cases:

Rosenfeld v. Black, 445 F.2d 1337	4,5,6
SEC v. Insurance Securities, 254 F.2d 642	4,5
Protective Committee v. Anderson, 390 U.S. 414 (1968)	6
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Cases (cont'd.)
Winkleman v. General Motors,
48 F. Supp. 490 (1942 7
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Percodani v. Rider-Maxson Corp.,
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No._____

MORRIE BENSON, Petitioner,

v.

ARTHUR NEWMAN, et al., Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Petitioner prays that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Second Circuit, entered in the above entitled case on June 29, 1972..*

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*Additional respondents are: Morey Silverman, Dorothy Goldberg, Howard M. Stein, Lawrence M. Greene, Julian Koenig, David B. Truman, Francis O. Wilcox, Jack J. Dreyfus, Jr., Lester R. Bachner, Herbert M. Diamond, William P. Rogers, Harold A. Weissman, Robert B. Woodward, Jerome K. Ohrbach, Samuel Strasbourger, Samuel M. Pearson, Jack J. Dreyfus, Sr., Robert F. Tulchin, John J. Cranley, Duncan H. Cameron, Raymond W. Schibowski, Thomas P. Bligh, The Dreyfus Corporation, Dreyfus & Co., The Dreyfus Fund Incorporated, and Rose Lerman.

CITATIONS TO OPINIONS BELOW

The opinion of the District Court for the Southern District of New York, Edward C. McLean, Judge, may be found in CCH Fed. Sec. L. Rep. ¶93,316, at 91,718 (1971), [1971-72 Transfer Binder] and is printed in Appendix B hereto, infra, p. 10. The opinion of the United States Court of Appeals is presently unreported, the slip opinion is printed in Appendix C hereto, infra, p. 20.

JURISDICTION

The Judgment of the United States Court of Appeals for the Second Circuit was entered on June 29, 1972, p. 19, infra. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether the stockholders of an investment advisor corporation is entitled to the profits from the sale of his stock when the position of trust and influence as a fiduciary has been used to influence the appointment of the successors to the corporate stock as investment advisor to the fund with which he held a contract up to the time of sale, and, if not so entitled, whether the prophylactic nature of the well-established principle that fiduciaries may not profit from the sale of their office can be bent to allow some profit to be made.

The question is also raised whether it is appropriate to approve a compromise settlement under Rule 23.1, Federal Rules of Civil Procedure, upon the basis that future judicial review or legislative action could affect the right to recovery or when the approval is founded upon uncertainty of the law related to the measure of damages.

STATUTES INVOLVED

The Statutory Provisions involved are Sections 2(a)(4), 15(a)(4), and 36 of the Investment Companies Act of 1940 (15 U.S.C.A. 80a) and Rule 23.1, Federal Rules of Civil Procedure. They are printed in Appendix A, infra, pp. 8.

STATEMENT

Three derivative actions were brought in the District Court for the Southern District of New York for the purpose of recovering the profit realized by selling stockholders of the corporate investment advisor to the Dreyfus Fund, Incorporated, a diversified open-end investment company registered under the Investment Company Act of 1940. The jurisdiction of the District Court was invoked under Rule 23.1, Federal Rules of Civil Procedure. These three actions were consolidated under the Authority of Rule 42(a) Federal Rules of Civil Procedure and thereafter proceeded on a single amended Complaint possessed of two theories of liability: (1) The Proxy statement was materially misleading, (2) A Fiduciary may not personally profit from the sale of his office. At trial, the testimony evolved around the claim of falsity of the Proxy statement, the facts being stipulated as to the sale of fiduciary office. Before the issue was determined, the parties executed a stipulation of settlement for $5,000,000.00 which was approved, after hearing, by Judge Edward C. McLean. See [1971-72 Transfer Binder] CCH, Federal Securities Law Reporter ¶93,316, at 91,718 (1971), printed in Appendix B, infra, p. 10. The Petitioner and one other stockholder of the Dreyfus Fund, Incorporated, appeared in opposition to the settlement pursuant to public notice of the settlement hearing in

financial publications. Upon approval of the settlement, appeal was taken to the United States Court of Appeals for the Second Circuit by both objecting stockholders asserting that the Order approving the proposed Compromise Settlement was entered contrary to law for failing to comprehend the measure of damages under the principle that fiduciaries may not profit from their office and for failing to meet the test of fairness in approving the settlement.

The Court below affirmed the Order of the District Court as reasonable in the light of uncertain legal and factual issues. Appendix C, infra, p. 20.

REASONS FOR GRANTING THE WRIT

1. The equitable principle that a person standing in a fiduciary relationship with another may not sell or transfer such office for personal gain has been found to govern the office of an investment advisor to a mutual fund by the U. S. Court of Appeals for the Second Circuit, Rosenfeld v. Black, 445 F. 2d 1337 (1971), U. S. App. Pending. The court then indicated that compliance with the duty required the elimination of any possibility of personal gain, P. 1342. This holding went through the financial community with a tremor of earthquake proportions. Up until the time of this decision, there was language in a decision from the Ninth Circuit which the Industry felt represented the law on this subject, SEC v. Insurance Securities, Inc., 254 F.2d 642 (1958) Cert. denied 358 US 823. The Court, proceeding under an action brought by the SEC under Sec. 36 of the Investment Companies Act of 1940, Appendix A, infra, p. 9, set forth the proposition that the Act was directed to the transfer of control without consent of the shareholders and not the money received by the assignors of service

contracts. In contrast, the Court in Rosenfeld found that the purpose of Section 15 of the Investment Company Act (terminating advisory contracts upon assignment) was to furnish additional protection to stockholders without foreclosing prior safeguards which might be afforded by equitable principles already available. The Court in the Rosenfeld case distinguished the Insurance Securities case as an action under Section 36 of the Act but acknowledged its disagreement with the passages in the Ninth Circuit's opinion regarding the right to recover the excess received by controlling stockholders over the book value of their stock in the investment advisor. Regardless of the legal distinctions which the Second Circuit found, this created a conflict in the financial community because of prior reliance of management companies upon the Insurance Securities language on this subject. Whether this is a true conflict which should be resolved by the Supreme Court or whether the Second Circuit astutely distinguished the decisions, the great confusion which follows in the wake of these decisions should be cleared up. The impact of these decisions is pointed up by the fact that such a vast amount of comment has been made in legal journals concerning these cases. A list of many such articles and comments may be found in Appendix C, infra, p. 31, footnote 14.

The proposed compromise settlement in the cause now presented for the Court's consideration, was strongly influenced by the Rosenfeld decision. However, the Petitioner asserts that the approval of the Court has not taken account of the prophylactic principle involved while contemplating the measure of damages applicable. It thus becomes necessary to resolve the confusion regarding the application of the equitable

doctrine that fiduciaries may not sell their office for a personal gain, to reach the ultimate question regarding the measure of damages. The present state of affairs would show that the equitable principle which is prophylactic in purpose may be subtly eroded away by the process of approving settlements pursuant to Rule 23.1 F.R.Civ.P., infra, p.9a.

2. While the District Court and the Court of Appeals expressed difficulty with the proposition of what profit might be for the purposes of determining the recovery under the Rosenfeld decision, it is submitted that all shareholders will be faced with the prospect that the Courts will continue to approve settlements on the basis that there is uncertainty in the law regarding the measure of damages. The stumbling block of damages, whether real or fanciful, effectively prevents the courts of original jurisdiction from giving due consideration and weight to all relevant factors necessary for a full and fair assessment when presented with proposed compromise settlements where the principle enunciated by the Rosenfeld decision arises. This Court made it very clear that considerations of proposed compromise settlements should involve a comprehensive consideration of all relevant factors to include an evaluation of facts and law so that an intelligent and objective opinion may be reached as to the probabilities of success in the litigation at hand, Protective Committee for Independent Stockholders of TMT Trailer Ferry Inc. v. Anderson, 390 U.S. 414, (1968). In order for the courts to properly consider a compromise settlement, it seems necessary that the courts adopt some measure of damages so that the difference between the amount sought and the compromise settlement may be weighed by the Court when approving or disapproving such settlements. Among other tests of fairness, this test appears to have

been frequently applied in these deliberations, Norman v. R. L. McKee, et al., 431 2d. 769(1970), Winkleman v. General Motors Corporation, 48 F. Supp. 490 (1942), Neuwirth v. Allen, et al., 338 F.2d 2(1964), Percodani v. Rider-Maxson Corporation, 50 F.R.D. 473 1970.

The law will always be uncertain regarding the computation of damages until the courts adopt some method of computation which can be tested by Appellate Courts. It is urged that the Court take jurisdiction to express the measure of damages for use by the lower Courts in like cases, or, to direct that the lower Courts determine the measure of damages so that all relevant factors may receive due consideration in settlements proposed under Rule 23.1 F. R. Civ. P. infra, p.9

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

Holmes Russell Troutman
Counsel for Petitioner

Morrie Benson
Pro Se

September 23, 1972

APPENDIX A

15 U.S.C.A. §80a-2. Definitions

(a) When used in this subchapter, unless the context otherwise requires--

(4) "Assignment" includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but does not include an assignment of partnership interests incidental to the death or withdrawal of a minority of the members of the partnership having only a minority interest in the partnership business or to the admission to the partnership of one or more members who, after such admission, shall be only a minority of the members and shall have only a minority interest in the business.

15 U.S.C.A. §80a-15. Contracts of advisers and underwriters

(a) It shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and--

(4) provides, in substance, for its automatic termination in the event of its assignment.

(b) It shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a

written contract with such company, which contract--

(2) provides, in substance, for its automatic termination in the event of its assignment.

15 U.S.C.A. ¶80a-36. Larceny and embezzlement

Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 80a-48 of this title. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts.

Aug. 22, 1940, c. 686, Title I, ¶37,54 Stat. 841.

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Rule 23.1

DERIVATIVE ACTIONS BY SHAREHOLDERS

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Added Feb. 28, 1966, eff. July 1, 1966.

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

ARTHUR NEWMAN, et al.,

Plaintiffs,

-against-

HOWARD M. STEIN, et al.,

Defendants.

68 Civ. 1398

OPINION

McLEAN, D. J.

The court is faced with the unusual problem of deciding whether or not to approve a proposal to settle this stockholder's derivative action which was made after the action had been fully tried and was awaiting the filing of final briefs. Presumably no such proposal would have been forthcoming were it not for the fact that shortly after the trial concluded on June 14, 1971, the Court of Appeals for the Second Circuit handed down its opinion in Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), a decision which has attracted considerable attention in the mutual fund industry. The bearing of that decision upon the present case is the principal question which this court must consider in order to determine whether this settlement proposal is reasonable and fair to the stockholders of The Dreyfus Fund Incorporated (the Fund) on whose behalf this action is brought. The nature of the issues involved in this case may be briefly described as follows.

The Fund is a diversified open-end investment company registered under the Investment Company Act of 1940 (15 U.S.C.

Sec. 80a-1 et seq.). During the period relevant here, The Dreyfus Corporation (the Corporation) was its investment adviser and principal underwriter. It had a management contract with the Fund. It charged for its services a fee at the annual rate of 1/2 of 1 per cent of the average daily market value of the Fund's net assets. Since the Fund's inception, these net assets had grown very substantially under the Corporation's management. As of September 30, 1965, they amounted to approximately $1,100,000,000. The fees of the Corporation had grown correspondingly. For the year 1965, they amounted to $5,108,977.

Dreyfus & Co. (the partnership) is a brokerage firm which is a member of the New York Stock Exchange and other exchanges. It was the Fund's principal broker and over the years made very substantial sums in commissions for buying and selling securities for the Fund. For the year 1965 these commissions totalled $2,398,107.

The individual defendants named in the complaint were partners in the partnership, or directors or officers of the Corporation, or directors of the Fund. Some of them occupied more than one of these positions.

Until October 25, 1965, the partnership owned all the stock of the corporation. As of that date, the stock was distributed to the individual partners. Jack J. Dreyfus, Jr., thereupon became the owner of 1,362,032 shares, which amounted to 53.41 per cent of the Corporation's stock. Other partners became the owners of smaller amounts.

On October 27, 1965, all the stockholders except two entered into an underwriting agreement for the public sale of all but five per cent of their shares of the

Corporation. Collectively, they agreed to sell 2,246,550 shares, which constituted approximately 88 per cent of the Corporation's stock. Of this total, Jack J. Dreyfus, Jr. agreed to sell 1,288,883 shares.

The selling stockholders agreed to sell their stock to the underwriters for $18,625 per share, which produced total proceeds for all the selling stockholders of $41,841,933.75. From this, certain expenses totalling approximately $515,000 were to be deducted, leaving net proceeds for the selling stockholders of $41,326,933.75. The underwriters resold the stock to the public at $20 per share.

The management contract between the Corporation and the Fund provided, as required by Section 15(a) (4) of the Act (15 U.S.C. Sec. 80a-15 (a) (4)), that it would terminate automatically in the event of its assignment by the Corporation. Under Section 2(a) (4) of the Act (15 U.S.C. Sec. 80a-2(a) (4)), the transfer of a controlling block of the Corporation's stock constituted an assignment. It was therefore necessary to obtain the approval of the Fund's stockholders to a new management contract to replace the one which would terminate upon the sale. The selling stockholders understood this.

At a meeting on July 22, 1965, and again at another meeting on August 25, 1965, the Board of Directors of the Fund voted to recommend to the stockholders of the Fund that they approved a new management contract between the Fund and the Corporation, on the same terms as the existing contract, to take effect when, as and if the sale by the selling stockholders of their stock in the Corporation became effective. The stockholders' meeting was called for October 25,

1965 and on October 5, 1965 a proxy statement was mailed to the stockholders which contained the Board of Directors' recommendation. At the meeting, the stockholders approved the new management contract by a large majority. Ninety-one per cent of the shares then voting, which constituted seventy per cent of the total outstanding shares, approved it. The sale was consummated as planned.

This action is a consolidation of three similar stockholders' derivative actions. In the pre-trial order plaintiffs defined their two principal contentions as follows:

(1) the sale of the controlling stock of the Corporation was a sale by the selling stockholders of their fiduciary office and accordingly the selling stockholders are required to account, ex maleficio, to the Fund "for the proceeds, or profits, of the sale";

(2) the proxy statement for the October 25, 1965 meeting of the stockholders of the Fund was false and misleading, primarily in two respects: (a) it failed to state that the selling stockholders would receive a price of $18.625 per share for their stock; (b) it failed to state that as a result of the sale, the Fund would no longer have an opportunity to induce the partnership to apply brokerage commissions due to it from the Fund in reduction of the management fee owed by the Fund to the Corporation. This was so, according to plaintiffs, because after the sale, the partnership and the Corporation would no longer be controlled by the same persons, and hence it would not be possible to accomplish a setoff of commissions against advisory fees, a setoff which might have been possible before the

sale, if the partnership could have been persuaded to agree to it.

The testimony at the trial was devoted primarily to the claim of falsity of the proxy statement. The contention as to the sale of fiduciary office was thought to raise essentially a question of law, inasmuch as the relevant facts, which have been briefly summarized above, were stipulated. Shortly after the trial concluded, the parties submitted to the Court for its approval a stipulation of settlement by which certain of the selling stockholders undertook to pay to the Fund sums aggregating $5,000,000 in full settlement of all claims against all defendants. The court directed that a hearing be held upon this proposal, on notice by publication to the stockholders of the Fund, and by mail to the Securities and Exchange Commission. At the hearing only two stockholders, owning between them approximately 4,550 shares of the Fund, appeared to oppose the application. Their holdings constitute only a tiny fraction of the 48,176,195 shares of the Fund which were outstanding as of September 29, 1965. The Securities and Exchange Commission did not appear. Special counsel for the Fund advised the Court that the Fund's Board of Directors had considered the proposal, believed it to be fair and reasonable, and requested that it be approved.

Despite the scantiness of the opposition to the proposed settlement, the Court is aware of its responsibility to scrutinize the proposal carefully. If, having heard the whole case, the Court were about to give judgment for plaintiffs in a sum substantially in excess of $5,000,000, the court could not in good conscience approve a settlement in that amount. This would be true even though the court appreciates that

its decision would not be the last word on the subject and that it might subsequently be overturned by the Court of Appeals or the Supreme Court. Thus, in this rather unique situation, the court has been compelled to consider the merits of plaintiffs' claims very much as it would have done if it were deciding the case rather than passing upon a settlement proposal.

As to plaintiff's attack upon the proxy statement, the court believes that defendants have the better of the argument. It is unnecessary to relate all the details of the testimony or to make formal findings of fact as one would do after a trial. For present purposes, it is sufficient to state the court's conclusion that the proxy statement was not false and misleading in any material respect. The court is satisfied that if this were the only claim in the case, the $5,000,000 settlement would be highly advantageous to the Fund and its stockholders. But this is not the only claim in the case, and therein lies the problem.

The facts here are essentially similar to those in Securities and Exchange Commission v. Insurance Securities, Inc., 254 F. 2d 642 (9th Cir. 1958), in which the court rejected the contention of the Commission that the sale of a controlling block of stock of the management corporation was a sale of a fiduciary office and constituted a "gross abuse of trust" under Section 36 of the Act. If it were clear that Insurance Securities constitutes the law on this subject, the court would have no difficulty in approving this settlement, if indeed there were any settlement proposal to approve. The difficulty arises because Rosenfeld v. Black, supra, raises grave doubt as to whether Insurance Securities is the law, at least in this circuit. In Rosenfeld, the

Court of Appeals, although it said that Insurance Securities was distinguishable from the case before it, took pains to state further with respect to that case that "we should not wish to be understood as accepting these views." 445 F.2d at 1346.

This, at the very least, is a broad hint which it would be unwise to ignore. Although this court is not now called upon to decide definitely whether the Rosenfeld rule applies here, the only safe basis upon which to consider the proposed settlement is to assume that it does.

To say this, however, is not to solve the problem. Even if we assume that the law in the Second Circuit, contrary to that in the Ninth, is that sellers of controlling stock of a management corporation, under circumstances present here, are accountable to the Fund for their profits, the question still remains as to how the profits are to be computed. In Insurance Securities, the Commission argued unsuccessfully that the profit was the difference between the proceeds of the sale and the net asset value of the shares sold. To apply such a rule in the present case would produce a very large recovery. The net asset value of all the Corporation's stock as of the end of June 1965 was $6,783,833. Approximately 88 per cent of the stock was sold. Eighty-eight per cent of $6,783,833 is $5,969,773.04. Deducting that figure from the net proceeds of $41,326,933.75 leaves $35,357,160.71 as the net profit to be recovered.

But in Rosenfeld, the Second Circuit did not adopt this theory or any other theory for the computation of profit. Inasmuch as the actual holding in that case was that the district court's order granting summary judgment for defendants be reversed, the court was not called upon to decide the

question of damages. Its opinion casts very little light on that subject beyond a brief discussion in a footnote of a law review article about the "difficulties in applying the principle prohibiting profit in the transfer of the advisory office to the sale of controlling stock in a corporate investment adviser," and a further reference in the same footnote to a suggestion in another law journal article "that the amount of unjust enrichment may be less when the same adviser is expected to continue." 445 F.2d at 1346 n. 12.

Defendants urge that the rule should be that the profits are the difference between the proceeds and the "going concern value" of the stock, rather than its net asset value. They argue that to employ that rule here would lead to the conclusion that the selling stockholders made no profit at all, because the going concern value of the stock which they sold was as great as the price which they received. Defendants say that this is so because of the excellent reputation which the Corporation enjoyed because the performance record of the Fund which the Corporation managed had been outstanding. Defendants point to the fact that with the exception of Jack J. Dreyfus, Jr., the personnel of the Corporation who were responsible for this performance would continue in the same capacities with the Corporation after the sale of the stock.

If this court were to disapprove the settlement and were to proceed to decide this case on the merits, it would be faced with two questions: (1) a question of law as to whether the going concern value of the stock is the proper figure to be deducted from the proceeds in order to determine the profit; (2) a question of fact as to what the going concern value is. As to the question of law, there is no controlling precedent

as far as the court has been able to discover. As to the question of fact, it is highly doubtful whether there is evidence in this record from which the going concern value could be computed with reasonable certainty. The court makes no prediction as to how it would resolve these questions. The result might turn out to be more than $5,000,000 or it might turn out to be less. Moreover, it is manifest that whatever result this court might reach, the inherent uncertainties are so great as to make it impossible to predict what would happen to the court's decision on appeal.

Under the circumstances, the court believes that it should not refuse to approve a settlement which both contending parties and the directors of the Fund desire and ask the court to approve, a settlement which will terminate this protracted litigation once and for all. $5,000,000 is by no means an inconsequential figure. There is no assurance, in view of the present state of the law in this area, that if this litigation went through to the bitter end, the Fund would eventually wind up with more. After full consideration, the court finds the proposed settlement to be fair and reasonable from the point of view of the Fund and its stockholders. The settlement is therefore approved.

A further hearing will be held on notice to all persons who have appeared on the question of the allowance to be made to plaintiffs' attorneys and on the application of attorneys for defendant Bachner for an allowance.

Settle order on notice.

Dated: December 29, 1971

/s/ Edward C. McLean
U. S. D. J.

APPENDIX C

UNITED STATES COURT OF APPEALS
For The
Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-ninth day of June, one thousand nine hundred and seventy-two.

Present: HON. HENRY J. FRIENDLY
Chief Judge

HON. J. EDWARD LUMBARD
HON. WILLIAM H. MULLIGAN
Circuit Judges.

Arthur Newman, et al.,
Plaintiffs-Appellees,
v.
Howard M. Stein, et al.,
Defendants-Appellees,
Morrie Benson and Joseph Lerman,
Objectants-Appellants.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed without costs in accordance with the opinion of this court.

A. Daniel Fusaro
Clerk

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 855, 856—September Term, 1971.

(Argued June 9, 1972 Decided June 29, 1972)

Docket Nos. 72-1386, 72-1502

ARTHUR NEWMAN, MOREY SILVERMAN, and DOROTHY GOLDBERG,

Plaintiffs-Appellees,

v.

HOWARD M. STEIN, LAWRENCE M. GREENE, JULIAN KOENIG, DAVID B. TRUMAN, FRANCIS O. WILCOX, JACK J. DREYFUS, JR., LESTER R. BACHNER, HERBERT M. DIAMOND, WILLIAM P. ROGERS, HAROLD A. WEISSMAN, ROBERT B. WOODWARD, JEROME K. OHRBACH, SAMUEL STRASBOURGER, SAMUEL M. PEARSON, JACK J. DREYFUS, SR., ROBERT F. TULCHIN, JOHN J. CRANLEY, DUNCAN H. CAMERON, RAYMOND W. SCHIBOWSKI, THOMAS P. BLIGH, THE DREYFUS CORPORATION, DREYFUS & CO., and THE DREYFUS FUND INCORPORATED,

Defendants-Appellees,

—and—

MORRIE BENSON and ROSE LERMAN,

Objectants-Appellants.

Before:

FRIENDLY, *Chief Judge.*
LUMBARD and MULLIGAN, *Circuit Judges.*

Appeal by two stockholders of The Dreyfus Fund Incorporated from an order of the District Court for the Southern District of New York, Edward C. McLean, *Judge*, [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,316, at 91,718 (1971), approving the settlement of an action to recover for the Fund profits from the public offering of a controlling block of the stock of The Dreyfus Corporation, the Fund's investment adviser and principal underwriter.

Affirmed.

ABRAHAM L. POMERANTZ, Esq., New York, N. Y. (William E. Haudek, Esq., Daniel W. Krasner, Esq., and Pomerantz Levy Haudek & Block, Esqs., of Counsel), *for Plaintiff-Appellee Newman.*

CHARLES TRYNIN, Esq., New York, N. Y., *for Plaintiff-Appellee Goldberg.*

LEIBOWITZ, MILBERG, WEISS & FOX, Esqs., New York, N. Y., *for Plaintiff-Appellee Silverman.*

STUART A. JACKSON, Esq., New York, N. Y. (John H. Carley, Esq., Frank J. Franzino, Jr., Esq., and Royal, Koegel & Wells, Esqs., of Counsel), *for Defendants-Appellees, The Dreyfus Corporation, et al.*

W. CROSBY ROPER, JR., Esq., and COVINGTON & BURLING, Esqs., Washington, D. C., *for Defendant-Appellee, The Dreyfus Fund Incorporated.*

H. RICHARD PENN, Esq., Charles B. Salfeld, Esq., and BACHNER, TALLY & MANTELL, Esqs., New York, N. Y., *for Defendant-Appellee Bachner.*

ROBERT B. LEVIN, Esq., New York, N. Y., (Bernard J. Coven P.C., of Counsel), *for Objectant-Appellant Lerman.*

RUSSELL TROUTMAN, P.A., Winter Park, Florida, *for Objectant-Appellant Benson.*

FRIENDLY, *Chief Judge:*

The Dreyfus Fund Incorporated (the Fund), a diversified open-end investment company registered under the Investment Company Act of 1940, is among the largest and has been one of the most successful mutual funds. The Dreyfus Corporation (the Corporation) has been its investment adviser, receiving for its services a fee at the annual rate of ½ of 1 percent of the average daily market value of the Fund's net assets. It has also been the Fund's principal underwriter, an activity for which it is paid by persons becoming stockholders in the Fund.[1] Until the transactions here at issue, all the stock of the Corporation was owned by Dreyfus & Co. (the partnership) a brokerage firm which is a member of the New York and other stock exchanges and, as the Fund's principal broker, earned very large commissions. On October 25, 1965, the partnership distributed the stock of the Corporation among its individual members.

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1 A March 3, 1965, prospectus for the Fund's shares, introduced in the court below, states the sales charge as 8¾% of the offering price, with a discount on that percentage available in certain large sales. At least during the period relevant in this case, the Corporation maintained no direct sales staff but only regional sales representatives who worked with local dealers. Accordingly, the income derived from the sales charge was divided between the Corporation and the local dealer, the former receiving ½ of 1%, the latter receiving the remaining 7¾%. Thus, for example, in 1964 and the first half of 1965 the total commissions resulting from sales of the Fund's shares amounted to $10,464,949 and $8,336,454 respectively, with the Corporation's share being $617,898 and $491,546 respectively.

This distribution of stock to the partners was the first step in a plan whereby 2,246,550 shares of the Corporation's stock, some 88%, were to be sold to underwriters who, in turn, would make a public offering. Since the transaction would constitute the sale of a controlling block, the sale would be an "assignment," Investment Company Act § 2(a)(4), of the advisory and underwriting contracts, which, under the terms required for such contracts by § 15(a)(4) and (b)(2), would automatically terminate them. A special meeting of the stockholders of the Fund was called, on October 25, 1965, to approve a new management contract with the Corporation, substantially identical with the existing one, recommended by the Fund's directors, which would be effective after the assignment. In addition to explaining the reason for the new management contract, the proxy statement, mailed on October 5, 1965, stated that the board of directors of the Fund had approved a new underwriting contract, also substantially identical with the existing one, which would come into effect simultaneously with the new management contract.[2] The statement further explained, *inter alia*, that the Corporation's and the Fund's methods of doing business would be essentially the same as theretofore; that the Corporation would continue to furnish the same investment personnel to the Fund, subject to normal turnover; that while, because of his membership in Dreyfus & Co., Jack J. Dreyfus, Jr., would not be eligible under the rules of the New York Stock Exchange to serve as an officer or director of the Corporation once it had become publicly owned, he would enter into a five year contract to render consulting services to the Corporation

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2 The apparent reason why the stockholders of the Fund were not asked to approve the new underwriting contract is that under § 15 (b)(1), unlike § 15(a)(2), approval by the board of directors suffices.

at an annual fee of $20,000[3] and he would continue as Chairman of the Board and an Investment Officer of the Fund; and that the partnership was expected to continue as the Fund's regular broker. The sale was to be underwritten "upon terms which have not yet been determined." The selling shareholders had indicated they would invest in the Fund not less than 50% of the net proceeds after taxes. If the stockholders did not approve the new management contract or if no steps in the proposed plan of distribution were taken, the existing management contract would continue in force.

The stockholders of the Fund approved the new management contract by a vote of 91% of the shares represented, which constituted 70% of the outstanding stock. On October 27 the selling stockholders agreed to sell their shares to the underwriters at $18.625 per share. A prospectus, effective on the same date, fixed the sales price to the public at $20 per share.

In 1968, three stockholders of the Fund brought derivative actions in the District Court for the Southern District of New York to recover for the Fund the profit realized by the selling stockholders.[4] Pursuant to F.R.Civ.P. 42(a), these three actions were consolidated and ordered to proceed on a single amended complaint. The complaint asserted two theories—that the transaction constituted a sale

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3 The evidence was that, due to poor health, Mr. Dreyfus, over the period 1961-1965, had gradually relinquished day-to-day supervision of the investment management program to Howard M. Stein and the men Mr. Stein had selected to assist him. In fact, this shifting of responsibilities was largely completed at least two years before the public distribution of the Corporation's stock.

4 These were: *Newman* v. *Stein, et al.*, 68-Civ.-1398; *Goldberg* v. *The Dreyfus Corporation, et al.*, 68-Civ.-2924; *Silverman* v. *Rogers, et al.*, 68-Civ.-2982. In 1969, objector Lerman instituted a fourth action in the Southern District on behalf of the Fund: *Lerman* v. *Dreyfus, et al.*, 69-Civ.-1786. This was not consolidated with the other actions.

of fiduciary office for personal gain, and that the proxy statement was materially misleading. After a trial devoted only to the latter claim since the facts with respect to the former were stipulated, this court handed down its decision in *Rosenfeld* v. *Black*, 445 F.2d 1337 (2 Cir. 1971), holding that profits realized by a retiring investment adviser of a fund from the successor it had caused to be installed were recoverable by the fund; to say the least, this gave considerable aid and comfort to plaintiffs' sale of office claim. Shortly thereafter the parties executed a stipulation of settlement, subject to court approval, for $5,000,000. After a hearing Judge McLean approved the settlement, see [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,316, at 91,718 (1971). Two stockholders of the Fund who opposed the settlement as inadequate have appealed from the order thereafter entered.

As we recently pointed out in *Saylor* v. *Lindsley*, 456 F.2d 896, 904 (2 Cir. 1972), the role of a court in passing upon the propriety of the settlement of a derivative or other class action is a delicate one. Quoting from an article by a member of the firm representing one of the plaintiffs in this action,[5] we recognized that since "'[t]he very purpose of a compromise is to avoid the trial of sharply disputed issues and to dispense with wasteful litigation,' the court must not turn the settlement hearing 'into a trial or a rehearsal of the trial.'" Rather, in the words of the Supreme Court, *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc.* v. *Anderson*, 390 U.S. 414, 424-25 (1968),[6] it must reach "an intelligent and

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5 Haudek, The Settlement and Dismissal of Stockholders' Actions—Part II: The Settlement, 23 Sw. L.J. 765 (1969).

6 *TMT Trailer Ferry* involved judicial approval of compromises in a Chapter X bankruptcy proceeding rather than of the settlement of a stockholder's derivative action. However, decisions in the one area have at times been cited in the other. Compare, e.g., *Upson* v. *Otis*, 155 F.2d 606, 614 (2 Cir. 1946) (bankruptcy decisions cited in con-

objective opinion of the probabilities of ultimate success should the claim be litigated" and "form an educated estimate of the complexity, expense, and likely duration of such litigation . . . and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise." See also *In re Prudence Co.*, 98 F.2d 559, 560 (2 Cir. 1938), *cert. denied*, 306 U.S. 636 (1939); *West Virginia* v. *Chas. Pfizer & Co.*, 440 F.2d 1079, 1086 (2 Cir.), *cert. denied*, 404 U.S. 871 (1971). We have also said, citing many cases, "that the approval of a compromise is a discretionary order which can be reversed only upon a clear showing of an abuse of discretion," *Connecticut Ry. & Lighting Co.* v. *New York, N.H.&H.R.R.*, 190 F.2d 305, 308 & n.3 (2 Cir. 1951); see *Upson* v. *Otis*, 155 F.2d 606, 612 (2 Cir. 1946); *West Virginia* v. *Chas. Pfizer & Co.*, *supra*, 440 F.2d at 1085, although the reasons for invoking this accordion-like principle in the context of settlements of stockholders' derivative suits do not seem altogether clear.[7] As said in *Protective Committee* v. *Anderson*, *supra*, 390 U.S. at 434, "[i]t is essential . . . that a reviewing

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text of stockholders' derivative action); *Saylor* v. *Lindsley*, *supra*, 456 F.2d at 904 (same); *Schleiff* v. *Chesapeake & O. Ry.*, 43 F.R.D. 175, 178 (S.D.N.Y. 1967) (same), with, e.g., *Ashbach* v. *Kirtley*, 289 F.2d 159, 163 (8 Cir. 1961) (stockholder action decisions cited in context of bankruptcy proceeding); *Wolf* v. *Nazareth Enterprises, Inc.*, 303 F.2d 152, 155 (2 Cir. 1962) (same).

7 One basis, at least where the district court had granted approval, might be that the policy favoring settlement is so strong that opposition should be made difficult. Another might be that, generally speaking, one judicial examination of an agreed disposition should suffice. However, there are opposing considerations in derivative or other class actions. See *Saylor* v. *Lindsley*, *supra*, 456 F.2d at 900-01. A partial explanation may lie simply in the influence of decisions reviewing approval of compromises in bankruptcy proceedings, see note 6, although the difference in the interest of a trustee from that of a plaintiff in a class action tends more strongly in favor of limited court of appeals review in such cases, especially when a district judge has approved the approval of a referee.

court have some basis for distinguishing between well-reasoned conclusions arrived at after a comprehensive consideration of all relevant factors, and mere boiler-plate approval phrased in appropriate language but unsupported by evaluation of the facts or analysis of the law." Thus, appellate courts have rejected approval of settlements where the trial court acted without sufficient facts concerning the claim, see, e.g., *Ashbach* v. *Kirtley*, 289 F.2d 159, 163-66 (8 Cir. 1961), or failed to allow objectors to develop on the record facts going to the propriety of the settlement, see, e.g., *Cohen* v. *Young*, 127 F.2d 721, 725-26 (6 Cir. 1942).[8] Similarly, clear error with respect to the law governing a defendant's liability may warrant reversal of the trial court's approval of a settlement. See *Upson* v. *Otis*, *supra*, 155 F.2d 606. But there is no problem here in these respects. The settlement occurred only after the completion of a full trial and neither objector has complained that the district judge subsequently prevented development of any further facts relevant to the settlement. As to matters of law, this appeal raises questions reflecting at most, as we shall see, uncertainty in the law, a factor which normally commends a compromise to a trial judge's discretion, see, e.g., *In re Prudence Co.*, *supra*, 98 F.2d at 560. Beyond these specific considerations, very likely all that is meant when appellate courts speak of the trial judge's discretion in this context is that in any case there is a range of reasonableness with respect to a settlement—a range which recognizes the uncertainties of law and fact in any particular case and the concomitant risks and costs necessarily inherent in taking any litigation to completion

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8 Also, essentially procedural flaws, such as inadequate class notice of settlement, cf. *Pittston* v. *Reeves*, 263 F.2d 328 (7 Cir. 1959), or inadequate attorney-client communication concerning the settlement, see *Saylor* v. *Lindsley*, *supra*, 456 F.2d 896, may undercut the integrity of the settlement process.

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—and the judge will not be reversed if the appellate court concludes that the settlement lies within that range.

Appellants arrive at their figure of potential recovery as follows: The net proceeds of the sale were $41,326,933.75. The share of the selling stockholders in the $6,783,833 net assets of the Corporation as of June 30, 1965, was $5,969,-773.04. Deduction of this leaves $35,357,160.71.[9] Appellants contend that a settlement for only one-seventh of that amount is so small as to fall below the lowest point in the range of reasonableness. Although at first blush the argument is not unpersuasive, we reject it on the facts of this case.

The district court dealt first with the claim that the proxy statement was false and misleading in a material respect. The principal claim in that regard was that the statement failed to give any information about the price the selling corporation stockholders would realize.[10] Con-

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9 A brief submitted on behalf of one of the directors of the Fund suggests that the maximum recovery would be only the net proceeds (less the share of net assets) realized by the *controlling stockholders* of the Corporation rather than by all selling stockholders. This was not considered by the district court, probably because the *partnership* had controlled the Corporation until two days before the sale and it would defy reality to make anything turn on the two days ownership by individual partners. We likewise do not consider whether the argument might have force in a case where minority holders joined with the holders of a controlling block in making a sale.

10 The only other claim defined in the pre-trial order was that the statement did not make clear that, after the Corporation had gone public, the Fund would no longer have an opportunity to induce the partnership to apply brokerage commissions from the Fund in reduction of the management fee. This is so obvious as not to require statement; moreover, the evidence was that the Fund had never attempted this up to the time of the public distribution of the Corporation's stock. At argument in this court appellants added some other claims: (1) that the proxy statement failed to state that the sale would effect a termination of the management contract, (2) that it did not sufficiently apprise stockholders that the Fund could avail itself of termination to negotiate a new contract on better terms or with a different investment adviser, and (3) that it did not inform

ceding that precision in the proxy statement would not have been possible, since the price was not firmly fixed until the evening before the sale, which was after the meeting of the Fund's stockholders, appellants say the statement could have given some notion of what the sellers contemplated, and, more specifically, that it could and should have been amended after October 13, when the principal underwriters reached an agreement with the selling shareholders that the price to the public would be in a range of $20 to $21 per share. While we tend to agree that more information could and should have been given, we doubt that a court would find the proxy statement omitted "to state any material fact necessary in order to make the statements therein not false or misleading," SEC Rule 14a-9(a), so as to support a recovery. The financial statements of the Corporation which were annexed to the proxy statement showed that the Corporation had earned 61 cents per share in 1964[11] and 44 cents per share in the first half of 1965.[12] It required no great acumen for a shareholder in the Fund to understand that the selling shareholders were not going to part with such valuable shares at their net asset value of $2.66. The stockholders

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the stockholders that the Fund would (or might) be entitled to recover any profits. Even assuming these claims to be still open despite the pre-trial order, we find them without merit. The first point was sufficiently disclosed, although not stated in so many words; indeed, this was what the meeting was all about. On the face of things the Fund did not have an opportunity to negotiate since the selling stockholders of the Corporation took the position that unless the Fund approved the new contract, they would continue with the existing one—although one may harbor reasonable doubt whether this position would have been maintained if determined opposition had developed. Apart from other considerations, the third point would have required the draftsman of the 1965 proxy statement to anticipate our *Rosenfeld* decision six years later.

11 As against 17 cents per share in 1960 and 37 cents in 1964.

12 As against 27 cents in the first half of 1964.

of the Fund were thus put on notice of the essential point that the sellers expected to realize proceeds considerably in excess of net asset value; if they had wished more nearly precise figures, they could have inquired. We thus agree with the district court that if the proxy statement had been the sole issue, the case would not have been settled except perhaps for its nuisance value, and that no significant fraction of the $5,000,000 settlement must be allocated to this claim.

On the other hand, the appellees, both defendants and plaintiffs, acknowledge that the claim with respect to the sale of fiduciary office was a substantial one; indeed, the defendants have acknowledged it to the tune of $5,000,000, no paltry sum. The arguments why so substantial a difference between this and appellants' figure of a maximum potential recovery of $35,000,000, can be justified may be divided into two principal categories: One concerns the continuing viability of *Rosenfeld* v. *Black;* the other consists of an asserted distinction of it and of arguments relating to the measurement of the profits realized.

The viability considerations also divide themselves into two sub-categories—judicial and legislative. While it would ordinarily be presumptuous for us to predict that the Supreme Court would ultimately deem an issue deserving of the grant of certiorari, we cannot disagree with experienced counsel for plaintiffs-appellees, or with the district judge who approved a settlement in the *Rosenfeld* case itself, 336 F. Supp. 84, 88 (S.D.N.Y. 1972) (Gurfein, *J.*), that this is an issue where certiorari almost surely would have been granted to review a plaintiffs' judgment in this action, unless some other case had preceded it.[13] Al-

13 Although a protective application for certiorari was filed in *Rosenfeld*, see 40 U.S.L.W. 3289 (U.S. Dec. 21, 1971) (No. 71-771), it has presumably not been pressed since the case was settled with the approval of the district court, 336 F. Supp. 84. The pending appeal

though we distinguished the *decision* in *SEC* v. *Insurance Securities, Inc.*, 254 F.2d 642 (9 Cir.), *cert. denied*, 358 U.S. 823 (1958), on what we believe to be a sound ground, 445 F.2d at 1346, we recognized our disagreement with "passages in the [Ninth Circuit's] opinion suggesting that in the court's view none of the excess of the price received by the controlling stockholders over the book value of their stock would be recoverable under any circumstances by stockholders of the investment company." *Id.* The importance of this conflict in approach has been heightened by the degree to which management companies, perhaps engaging in some wishful thinking, had relied on what the Ninth Circuit said in *Insurance Securities* rather than on what it decided. Beyond this, *Rosenfeld* has attracted what for us is an almost unparalleled amount and variety of comment in legal journals.[14]

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from that decision does not involve the propriety of approval but only whether stockholders of the fund who had redeemed their shares subsequent to the transfer of the advisory office may participate in the proceeds.

14 See, e.g., Butowsky, Fiduciary Standards of Conduct Revisited—Moses v. Burgin and Rosenfeld v. Black, 17 N.Y.L. Forum 735, 752-66 (1971); Nutt, A Study of Mutual Fund Independent Directors, 120 U. Pa. L. Rev. 179, 202-05, 242-46 (1971); Keeffe, "Undivided Loyalty" Prescribed for Mutual Fund Managers, 58 A.B.A.J. 209 (1972); Note, Fiduciary Requirements and the Succession Fee Upon the Change of Mutual Fund Advisers, 85 Harv. L. Rev. 655 (1972); Note, Mutual Fund Control-Transfer Profits: Congress, the SEC, and *Rosenfeld* v. *Black*, 58 Va. L. Rev. 371 (1972); Comment, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich. L. Rev. 696, 724-27 (1972); The Second Circuit Review, 38 Brooklyn L. Rev. 909, 1225 (1972); Second Circuit Note [1970 Term], 46 St. John's L. Rev. 405, 531 (1972); 40 Geo. Wash. L. Rev. 312 (1971); 46 N.Y.U.L. Rev. 1029 (1971); 40 Fordham L. Rev. 997 (1972); 60 Geo. L.J. 825 (1972); 50 Texas L. Rev. 583 (1972); 41 U. Cinn. L. Rev. 244 (1972). While there has been little disagreement with the imposition of fiduciary status upon the investment adviser with respect to the sale of his office, but see 50 Texas L. Rev. at 588-89, a substantial amount of discussion has concentrated on tempering the pro-

If certiorari were granted, we would, of course, hope to have our view affirmed. But Plautus warned long ago "what a ticklish thing it is to go to law," and the ticklishness does not diminish as the pinnacle is reached. Here we have the further imponderable, developed *infra*, whether the SEC might appear as *amicus curiae* and ask that the decision against it in the *Insurance Securities* case should be adopted as the governing rule and the effect which such a representation might have upon the Supreme Court. Cf. *Udall* v. *Tallman*, 380 U.S. 1, 16 (1965).

The threat on the legislative side may be greater still. Within a few months after the *Rosenfeld* decision, the Chairman of the SEC was quoted as saying that although the opinion was "well reasoned and well grounded on basic principles of fiduciary law," it was "harsh on people who are in the business [of advising investment companies] and it may call for legislative redress." [15] Encouraged by this, the Investment Company Institute (ICI) sent to the Senate a bill that would add a new subsection to § 15 of the Investment Company Act as follows:

> (f) No person shall be subject to any liability in any action or proceeding commenced prior to or on

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hibition on gain from such sales either by defining the standard of fiduciary duty as less than absolute or by allowing various defenses to be set up, some consideration of the "fairness" of the transaction generally being the focal point in either case. See Note, *supra*, 52 Va. L. Rev. at 407-16; 40 Geo. Wash. L. Rev. at 319-20; 46 N.Y.U.L. Rev. at 1039-44; 60 Geo. L.J. at 835-37; 41 U. Cinn. L. Rev. at 163-8. Beyond the standard of liability, the question of the proper measurement of the adviser's gain from the sale of his office, an issue not directly before us in *Rosenfeld*, has also received significant consideration. See Butowsky, *supra*, 17 N.Y.L. Forum at 763-85; Note, *supra*, 85 Harv. L. Rev. at 664-65; Note, *supra*, 52 Va. L. Rev. at 415 n.216; 50 Texas L. Rev. at 587-88.

15 N.Y. Times, Sept. 12, 1971, § 3, at 3, col. 1 & at 14, Col. 4, quoted in Brief for Plaintiffs-Appellees at 10-11.

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or after the date of the enactment of this subsection on the basis that such person has paid or received payments or profits in connection with a transaction *after April 7, 1958* whereby an interest in an investment adviser to a registered investment company has been or shall be sold or otherwise transferred or whereby any third person succeeded or shall succeed to any relationship between such adviser and such investment company, except to the extent that any terms, conditions or understandings, express or implied, in connection with such payment or receipt have imposed or shall impose an unfair burden on the investment company.[16] (Emphasis added)

While expressing some doubts about the terms of this amendment, the SEC, on March 10, 1972, advised Senator Williams that it intended shortly to recommend legislation that "would permit an investment adviser and its owners to obtain compensation, including profit, in connection with transactions which result in an assignment of an advisory contract if certain conditions are met." BNA Sec. Reg. & L. Rep., No. 146, at I-1 (April 5, 1972). If the SEC and the ICI should join forces,[17] it is not clear just who would take up the cudgels in favor of "basic principles of fiduciary law." Indeed, even if the SEC's recommended legislation were to operate only *in futuro*, as its reference to conditions giving some safeguards to shareholders may imply, it is not hard to envision a combination of such legislation for the future and the ICI's bill for the past; the watering down of the SEC's pre-

16 April 7, 1958, was the date of the *Insurance Securities* decision by the Ninth Circuit.

17 Counsel for plaintiffs-appellees referred to this at argument as "an extraordinary item on the American scene."

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vious reform proposals concerning mutual funds,"[18] after four years of struggle in Congress, Pub. L. No. 91-547, 84 Stat. 1413 (1970), is a vivid demonstration that its recommendations, when confronted by industry opposition, are not likely to emerge from Congress at the same strength with which they entered. While a retroactive provision would hardly affect a judgment that had become final, continued prosecution of this action would have afforded the selling stockholders and other management companies a powerful impetus to get such legislation on the books before the inevitable appellate process had been concluded.

Counsel for appellants has deftly pointed out, though, that the stipulation of settlement in this case was signed on July 9, 1971, some two months before the Chairman of the SEC gave any public indication of the Commission's position following *Rosenfeld*. It is argued that without this strong encouragement the ICI proposal which, it is suggested, had in fact been "kicking-around" for a number of years did not pose a serious threat to the *Rosenfeld* decision and that the possibility of legislative action was therefore not a real consideration *at the time* the stipulation was signed. In retrospect it is impossible to determine precisely what role the ICI proposal alone properly played in the parties' original decision to settle. Even if the proposal had been "kicking-around" for some time without generating much interest, *Rosenfeld* suddenly provided the industry with a significant stimulant to action which had theretofore been lacking, given the *Insurance Securities* decision—a fact of which the parties were undoubtedly cognizant at the time they signed the stipulation. In any event, evaluation of the propriety of a settlement requires realistic consideration of facts which affect the ultimate

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18 Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong. 2d Sess. (1966).

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likelihood of success, and it would be inappropriate for a reviewing court to freeze matters as of the moment at which the parties entered into an agreement and ignore subsequent developments which either reinforce or undermine the original decision to settle. Compare *System Meat Co.* v. *Stewart*, 163 N.W.2d 789, 792 (Neb. 1969).

Turning to the second category of arguments, an asserted distinction between this case and *Rosenfeld* and questions relating to the measure of damages, we wish to make crystal-clear that our observations do not connote either approval or disapproval. We refer to these points only as arguable ones that would merit consideration, without indicating any view what the result of such consideration should be:

(1) Defendants-appellees say that this case differs from *Rosenfeld*, and also from a case like *Insurance Securities* where holders of a controlling block sold to another group that supplanted them in the management of the adviser, in an essential way. This is that, from a practical rather than a legalistic frame, there was here no "termination" of an investment adviser but rather a provision for continuation of the one that had operated so successfully in the past. Thus, the proxy statement sent to the Fund's stockholders asserted in part that "[t]he Corporation's proposed method of doing business, assuming the adoption of the new management contract and underwriting contract, will be essentially the same as at present." In other words, while the Corporation's stockholders sold their stock at a profit, the argument is that they did not in reality sell their office.[19] In further support

19 An argument against this is that the price paid for the stock would inevitably figure in any efforts to reduce the management fee. The proxy statement noted that "[t]he Fund is the only mutual fund of

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of this, defendants-appellees point to the item in the proxy statement wherein the Fund's stockholders were informed that if they did not approve the proposed public offering, the Corporation would continue as theretofore.

(2) [20]*Rosenfeld* dealt with a company whose sole continuing activity vis-a-vis the fund was as an investment adviser, since, unlike most open-end funds, shares were not currently offered. Here the Corporation was both investment adviser and principal underwriter. Our holding of a fiduciary relationship between an investment adviser and the fund would not necessarily entail a similar holding with respect to an underwriter, whose compensation does not come from the fund and whose activity does not directly affect the money invested by the fund's shareholders. Some 17% to 18% of the Corporation's after tax income in 1964 and the first half of 1965 was estimated to have come from distribution activities. Arguably an equivalent proportion of the "profits" should be deducted.

(3) Since *Rosenfeld* came before us on appeal from a summary judgment dismissing the complaint, we were not obliged to determine how the profit of the retiring adviser should be measured. However, we noted, 445 F.2d at 1346 n.12, law review comments concern-

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its size which pays a management fee which does not decline with respect to increments of net assets above a base amount." But the Corporation would naturally be even more reluctant than previously to a change in terms that would substantially reduce the earnings that had been disclosed to those who had bought the stock at $20 per share, even though the prospectus had properly advised of the short duration of the management and underwriting contracts.

20 This point, while not raised by appellees, seems worthy of note subject to the general caveat expressed above.

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ing "[s]ome difficulties in applying the principle prohibiting profit in the transfer of the advisory office to the sale of controlling stock in a corporate investment adviser" and arguing "that the amount of unjust enrichment may be less when the same adviser is expected to continue," without taking any position thereon.

Defendants-appellees argue that, quite apart from its power over stockholder choice, the Corporation had a value greater than its net assets, predominantly cash, marketable securities, and receivables from dealers, listed in its balance sheet. With its impressive record of performance, the Corporation would have had little difficulty in forming a new fund or in selling its services to existing ones or to other institutional investors. Although the value deriving from this potential would hardly have been as great as the capitalization of the Corporation's earnings as adviser to a fund which had grown to some $937,400,000 in net assets as of mid-1965 and had paid $2,290,203 in management fees in the first six months of 1965, the Corporation, even after termination of its contracts with the Fund, would be worth something more than the figure shown in the balance sheet. Going beyond this, we encounter more extensive but less persuasive "going concern" value theories, ranging from the suggestion that account should somehow be taken of the likelihood of future renewals simply on the basis of performance and without regard to the Corporation's influence on the board of directors and control of the proxy machinery[21] to the extreme that the stock necessarily was

[21] It is not clear how such a prognostication could reflect the possibility of reductions in the Corporation's fee at the insistence of the Fund's board of directors, see § 15(c), or by litigation, now somewhat

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worth what the underwriters were willing to
with the inevitable corollary that there could nev
a profit on the sale of a controlling block.

When all these dubieties are considered in combin
as they must be, it becomes apparent that appellants'
ture of a practically assured recovery of $35,000,000
reality. The $5,000,000 settlement may not have
brilliant one for the plaintiffs—a question only time
resolve. However, with all relevant factors being
into account, as the district judge did, we cannot say
the settlement fell below the lowest point in the zone
reasonableness.

The judgment is affirmed. Since we believe appell
have performed a useful service in bringing this
before us, each party will bear its own costs.

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facilitated by § 15(c) and by § 35(b), added by Pub. L. No.
84 Stat. 1428 (1970). Indeed, the phenomenon of numerous
of management companies (or of controlling blocks) or the
tion of a new adviser (as in *Rosenfeld*) at substantial
existing fees, including cases where the adviser's performance
in no way outstanding, casts doubt on a fundamental premise
Investment Company Act, namely, that shareholders of mutual
are significantly protected by the requirements of § 15(a) for
renewals every two years. The SEC Mutual Fund report stated
even when there is a change in management, "[t]he Commission
of no instance where fund shareholders have rejected a new
contract proposed by their managers in connection with a
them of the management organization." *Supra* note 18, at 139.
also *id.* at 125-43.

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